

FAIR POLITICAL PRACTICES COMMISSION

Memorandum

To: Chairman Johnson; Commissioners Hodson, Huguenin, Leidigh, and Remy

From: Valentina Joyce, Commission Counsel
Scott Hallabrin, General Counsel

Subject: Amendment of Regulation 18705.1: Materiality Standards for Determining if a Governmental Decision will have a Material Financial Effect on a Public Official's Economic Interest in a Business Entity.

Date: March 27, 2009

Proposed Commission Action and Staff Recommendation: Adopt amendments to Regulation 18705.1 streamlining and clarifying the materiality standards used in determining whether a decision by a public official will have a material financial effect on his or her economic interest in a business entity.

Reason for the Proposal: The conflict-of-interest provisions of the Political Reform Act (the "Act") provide that "no public official at any level of state or local government shall make, participate in making or in any way attempt to use his official position to influence a governmental decision in which he knows or has reason to know he has a financial interest." (Section 87100). The Act further provides that a public official has a financial interest in a decision if it is reasonably foreseeable that the decision will have a *material* financial effect on, among other things, the official, a member of the official's immediate family, or any business entity in which the public official has a direct or indirect investment worth \$2,000 or more. (Section 87103(a).) To implement these provisions, the Commission adopted Regulation 18705.1 establishing materiality standards to apply to business entities in which a public official has an economic interest to determine if a conflict of interest exists.

When a public official has an economic interest in a business entity, the materiality standards vary according to the size of the business entity. Regulation 18705.1 sets forth two standards depending on whether the business entity is directly or indirectly involved in a governmental decision. (Regulation 18705.1(b) and (c).) For business entities directly involved in a governmental decision, the general rule is that the financial effect is presumed to be material. For business entities indirectly involved in a governmental decision, the applicable materiality standards are defined in terms of the size of business entities by looking to whether the entities (i) are listed on the Fortune 500, the New York Stock Exchange, the American Stock Exchange or the NASDAQ, (ii) meet a specified fixed dollar threshold for earnings before taxes or net income, or (iii) if not listed, in their most recent fiscal year, had earnings that met the listing requirements of the various exchanges.

The regulation's treatment of like-sized companies, whether or not listed on an exchange, is not carried through in its treatment of companies that are as large as Fortune 500 companies but are not listed in the Fortune 500. The proposed amendment would apply the same materiality standard for Fortune 500 companies to companies that are as large as these companies but are not listed in the Fortune 500. This standard would apply to business entities with revenues no less than the business entity that ranks 500th in the Fortune 500 list. This information is easily obtainable by a public official as it is available on several internet sites. This change would bring unity to the treatment of like-sized companies.¹

Staff is also proposing revision of the standard currently used for companies that are not listed on any stock exchange but may be eligible for listing. The current standard uses a fixed dollar threshold, or in the alternative, the meeting of listing requirements for the specific exchange. Listing requirements for the various exchanges change from time to time, have become increasingly complex, and do not always track the language of the regulation.² Eliminating this seldom used standard in favor of the dollar threshold would streamline and clarify the materiality standards.

Finally, the regulation uses different definitions of earnings in applying materiality standards. In most cases, "before tax earnings" is used and in one instance "net income" is used. In an effort to track the NASDAQ and AMEX requirements for companies not listed on either exchange, subdivision (c)(3) refers to two thresholds, *net income* of no less than \$500,000 and *earnings before taxes* of no less than \$750,000. It is unclear when to apply which standard. Corporations most commonly use "net income" when reporting financial results. For simplification purposes, staff recommends that a single measure be used, the preferred one being "net income," one that is easily ascertainable by reference to a company's financial statements.

Summary of Proposed Actions: Staff recommends language amending Regulation 18705.1 that would: (i) establish the same materiality standard applicable to Fortune 500 listed companies to those companies with revenues equal to or greater than the company that is 500th on that list; (ii) eliminate as a materiality standard earnings requirements established by various stock exchanges for listing on these exchanges; and (iii) replace "earnings before taxes" with

¹ There is an exception to the general rule for small investments in large companies. If the public official's investment is \$25,000 or less, the standards applicable to indirectly involved businesses are applied to companies listed in the Fortune 500 or on the New York Stock Exchange. The same amendment noted above will be made to the exception to conform the exception to the rule.

² For example, subdivisions (b)(2)(B) and (c)(2) define a materiality standard for a company not listed on the New York Stock Exchange, but having *earnings before taxes in its most recent fiscal year* in an amount described in the New York Stock Exchange's Company Manual "or such other amount described at Rule 102.01(C) of the New York Stock Exchange's Listed Company Manual (or any superseding rule of the New York Stock Exchange describing its financial standards for initial listing)". The exchange, however, no longer has an earnings requirement that applies to just one year. Instead, a company must have specified earnings in the aggregate over a three year period, minimum earnings in a specified amount in each of two years, and positive earnings in all three years. In addition, there are two other methods by which a company may qualify for listing that are unrelated to earnings: a "valuation/revenue" test and an "affiliated business" test. These criteria no longer fit within the concept of our regulation, which is to identify companies by their "earnings" for the "most recent fiscal year."

“net income” as the sole measure of earnings where a fixed dollar amount is used for determining the applicable materiality standard.

Attachments:

- 1 – Regulation 18705.1
- 2 – Government Code Section 87100
- 3 – Government Code Section 87103